



Issue Date	April 30, 2008
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Audit Report Number	2008-CH-1008
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TO: Robert E. Nelson, Director of Public Housing Hub, 5FPH

FROM: 
Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: The Lansing Housing Commission, Lansing, Michigan Failed to Follow HUD's Requirements for Its Nonprofit Development Activities

HIGHLIGHTS

What We Audited and Why

We audited the Lansing Housing Commission's (Commission) nonprofit development activities. The review of public housing authorities' development activities is set forth in our fiscal year 2007 annual audit plan. We selected the Commission because it was identified as having high-risk indicators of nonprofit development activity. Our objective was to determine whether the Commission diverted or pledged resources subject to its annual contributions contract (contract), other agreement, or regulation for the benefit of non-U.S. Department of Housing and Urban Development (HUD) developments.

What We Found

The Commission defaulted substantially on its contract when it improperly pledged resources for the benefit of the Lansing Housing Commission Nonprofit Development Corporation (Corporation) and the Oliver Gardens Limited Dividend Housing Association Limited Partnership (Partnership), organizations created by the Commission without HUD approval. In May 2006, the Commission inappropriately and without conditions guaranteed the obligations of the Partnership's general partner, the Oliver Gardens Limited Liability Company, in a guaranty agreement. Further, the Commission executed another guaranty agreement in September 2006 that unconditionally and irrevocably guaranteed the

full and punctual payment of a loan entered into by the Corporation. As of February 29, 2008, the Commission has placed \$1.4 million in federal assets at risk by entering into the guaranty agreements which made it responsible for all operating deficits and potential judgments of the Corporation and Partnership. The Commission also inappropriately used more than \$745,000 in Public Housing funds for two nonfederal developments, Oliver Gardens and The Abigail.

Lastly, the Commission managed and provided Section 8 housing assistance to the Oliver Gardens, a 30-unit senior housing project that the Partnership owns, and it performed unit inspections of the project's units, thus creating a conflict of interest.

We informed the Commission's executive director and the Director of HUD's Detroit Office of Public Housing of minor deficiencies through a memorandum, dated April 17, 2008.

What We Recommend

We recommend that the Director of HUD's Detroit Office of Public Housing require the Commission to amend the guaranty agreements regarding the Corporation and the Partnership to remove the Commission's pledging of its federal assets, submit the amended guaranty agreements to HUD for review and approval to ensure that they comply with its contract with HUD, reimburse the applicable programs for the improper use of Public Housing funds and its receipt of Section 8 administrative fees related to Oliver Gardens, contract with an independent third-party to perform housing quality standards inspections of Oliver Gardens as required by HUD, and implement procedures and controls to address the findings cited in this audit report. We also recommend that the Director refer the Commission's substantial default of its contract to HUD headquarters and request appropriate action be taken against the Commission.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06 REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided our discussion draft audit report to the Commission's executive director, its board president, and HUD's staff during the audit. We held an exit conference with the Commission on March 28, 2008. We asked the Commission's executive director to provide comments to our discussion draft report by April 10, 2008. The executive director provided written comments, dated, April 10, 2008. The executive director generally agreed with our findings

and recommendations with the exception that the Commission's Public Housing funds were not available for its intended purposes, and unit inspections and rent reasonableness determinations were improper. The complete text of the written comments, except for two attachments consisting of four pages of documentation that were not necessary to understand the Commission's comments, along with our evaluation of that response, can be found in appendix B of this report. A complete copy of the Commission's comments plus the documentation was provided to the Director of HUD's Detroit Office of Public Housing.

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BACKGROUND AND OBJECTIVE

The Commission is a public housing agency created by the City of Lansing (City), Michigan on August 2, 1965, to provide decent, safe, and sanitary housing for low- and moderate-income families under the Housing Act of 1937. The Commission entered into contracts with the U.S. Department of Housing and Urban Development (HUD). Under its annual contributions contract (contract), the Commission operates 833 units of subsidized housing in the City for its Public Housing program. Under a separate contract with HUD, the Commission manages a Section 8 Housing Choice Voucher (Section 8) program with subsidies for 1,700 vouchers for qualifying low- and moderate-income households. The Commission also received Shelter Plus Care grant funds to address homelessness in the City from HUD's Office of Community Planning and Development. Further, the Commission operates a homeownership program under an administrative use agreement with HUD, dated April 1, 1993. This program is funded from monies forgiven by HUD under the Turnkey III Homeownership Program. As of December 31, 2007, the Commission has funded 10 homeownership properties since 1993.

In July 2003, the Commission formed the Lansing Housing Commission Nonprofit Development Corporation (Corporation), a 501(c)(3) nonprofit entity, to promote the advancement of affordable housing through loans, development, and other financial and technical assistance. The Corporation and its nonfederal developments (Oliver Gardens and The Abigail) are instrumentalities of the Commission. The Commission is a member of the Corporation and oversees its affairs.

The Commission also formed the Oliver Gardens Limited Dividend Housing Association Limited Partnership (Partnership) on June 21, 2005, to provide housing for low- and moderate-income families. The Partnership constructed the Oliver Gardens development on land obtained from the Commission. The Commission provides Section 8 housing assistance to and manages the Oliver Gardens Section 8 Project-Based Voucher program for the Partnership.

On October 13, 2006, the Corporation purchased a large track of land formally known as the School for the Blind to develop a portion of the land for low-income housing and for the Commission's administrative offices. In April 2007, the Corporation formed the Abigail Limited Dividend Housing Association Limited Liability Company (Company) to own and operate low- and moderate-income housing on the land purchased from the Corporation.

A five-member board of commissioners, appointed by the City's mayor governs the Commission. HUD has classified the Commission as a standard performer or a high performer under its Public Housing Assessment System since fiscal year 1999. The Commission's books and records are located at 310 Seymour Avenue, Lansing, Michigan.

Our objective was to determine whether the Commission diverted or pledged resources subject to its contract, other agreement, or regulation for the benefit of non-HUD developments.

RESULTS OF AUDIT

Finding 1: The Commission Substantially Defaulted on Its Contract and Inappropriately Used Public Housing Funds for Nonfederal Development Activities

The Commission substantially defaulted on its contract when it executed guaranty agreements related to the Corporation's and the Partnership's nonfederal developments. It improperly and without conditions guaranteed the obligations of the Partnership's general partner, the Oliver Gardens Limited Liability Company in May 2006. Further, the Commission unconditionally and irrevocably guaranteed the full and punctual payment of a loan entered into by the Corporation in September 2006. The Commission also inappropriately used Public Housing funds for the nonfederal developments. These conditions occurred because the Commission lacked procedures and controls to ensure that it complied with federal requirements. As a result, more than \$1.4 million of the Commission's federal funds could be subject to seizure in the event of default on the agreements and more than \$745,000 of the Commission's Public Housing funds were not available for their intended purpose.

Guaranty Agreement Violates the Commission's Contract

On September 7, 2006, the Commission executed a guaranty agreement with the Local Initiatives Support Corporation to induce it to enter into and disburse \$867,900 pursuant to a loan agreement in order for the Corporation to purchase land to develop The Abigail, a nonfederal development. The Commission did not seek prior approval from HUD before entering into the agreement.

The guaranty agreement makes the Commission unconditionally and irrevocably responsible for all liabilities under the Corporation's loan agreement. The agreement states that the Commission is responsible for the loan agreement and all other indebtedness, obligations, and liabilities of the Corporation under or in connection with the agreement whether for principal, interest, fees, expenses, or otherwise including without limitation any and all reasonable expenses that may be paid or incurred by the Local Initiatives Support Corporation in collecting any or all of the obligations or enforcing any rights under the agreement. The note stipulates that payment of the principal balance and unpaid interest are due by October 1, 2009.

Further, the guaranty agreement warrants to the Local Initiatives Support Corporation that no authorization, consent, approval, license, exemption of or filing a registration with any court of government department, commission, board, bureau, agency, or instrumentality is or will be necessary to the valid execution,

delivery, or performance of the agreement. Additionally, the Commission warrants that execution of the agreement would violate no law, rule, regulations, writ, judgment, injunction, or decree.

The terms of the guaranty agreement amount to a pledge of the Commission's assets without limitation or restriction of the source of funds. As of January 2008, the Commission was entirely dependent on HUD for its funding and lacked any nonfederal assets or income.

**Guaranty Agreement
Inappropriately Encumbered
Public Housing Funds**

On May 9, 2006, the Commission executed a guaranty agreement with the National Equity Fund Assignment Corporation to induce it to invest in the Partnership. The agreement relates to the Partnership's nonfederal development, Oliver Gardens.

The Commission guaranteed the due and punctual performance by the Partnership's general partner, Oliver Gardens Limited Liability Company, of all of its obligations under the terms of the Partnership and development agreements. The guaranty agreement states that the liabilities of the Partnership's general partner will not exceed the total sum of payments received by the Commission from the Partnership including but not limiting to the development fee. Under the terms of the development agreement, the fee was \$561,933. Further, the guaranty agreement provides that the Commission will directly or indirectly through affiliates receive certain fees and other benefits from the development of the Oliver Gardens development. Per this statement, the Commission could possibly be responsible for an affiliate's funds due under the guaranty. Hence, the guaranty makes the Commission unconditionally responsible for all obligations of the Partnership's general partner.

Further, the guaranty agreement provides that the Commission indemnify the National Equity Fund Assignment Corporation. The agreement also states that the Commission hereby agrees to indemnify and hold the Partnership and the National Equity Fund Assignment Corporation free and harmless from and against actual loss, cost, damage, and expenses including reasonable attorneys' fees and costs that the Partnership or the National Equity Fund Assignment Corporation may sustain because of the inaccuracy or breach of any of the representations and warranties.

The Commission Transferred Public Housing Funds to Nonfederal Developments

The Commission inappropriately used \$745,436 (The Abigail \$499,716, Oliver Gardens \$230,760¹, and the Corporation \$14,960) in Public Housing funds for nonfederal development activities as of June 30, 2007. It began inappropriately using Public Housing funds in September 2004. As a result, the Commission's Public Housing funds were not available for their intended purpose, which is to provide decent, safe, and sanitary housing for low-income families, the elderly, and persons with disabilities for HUD-approved housing projects.

The Commission's contract allows it to withdraw money from its Public Housing funds only for payment of the costs and operation of the projects covered under the contract. The nonfederal developments were not approved projects under the contract. PIH Notice 2007-15 states that Public Housing funds may be used for costs related to forming an affiliate or instrumentality; however, the development must contain Public Housing units. HUD's Notice further states funds may be withdrawn from the Commission's general fund only for: (1) the payment of the costs of development and operation of projects under contract with HUD, (2) the purchase of investment securities approved by HUD, and (3) such other purposes as may be specifically approved by HUD. The Commission did not obtain HUD approval for the use of the Public Housing funds related to the nonfederal developments.

The Commission Lacked Procedures and Controls

The Commission lacked procedures and controls to address developing, constructing, financing, and operating nonfederal properties. Its board of commissioners also did not employ a monitoring process to ensure that the Commission did not use Public Housing funds for its nonfederal developments without prior HUD approval.

The executive director said he was not aware that the guaranty agreements did not comply with the terms of the contract nor did the Commission's legal counsel advise him of the noncompliance. He also said the Commission's legal counsel did not identify any problem with the guaranty agreements and considered them as normal routine agreements required by the investor when there is a lack of experience or satisfactory financial position by the borrower.

¹ The \$230,760 includes \$163,529 in insurance proceeds the Commission received in May 2001 and June 2007 resulting from two fires in February 2000, that occurred at the Commission's Oliver Towers. The Commission received approval for disposition of Oliver Towers from HUD's Special Applications Center in May 2001.

Unless the Commission implements procedures and controls to address developing, constructing, financing, and operating nonfederal developments, we estimate that it could improperly pledge or use \$652,581 in federal funds over the next year. We determined this amount by adding the \$867,900 for the guaranty agreement related to the Corporation, the \$561,933 for the guaranty agreement related to the Partnership, and the \$745,436 of Public Housing funds used for the nonfederal developments divided by 40 months (total time for the improper pledging and use of Public Housing funds) times 12 months.

Recommendations

We recommend that the Director of HUD's Detroit Office of Public Housing require the Commission to

- 1A. Amend the guaranty agreements related to the pledging of the Commission's federal assets for the Corporation (\$867,900) and the Partnership (\$561,933) to protect the \$1,429,833 cited in this finding.
- 1B. Submit the amended guaranty agreements to HUD for review and approval to ensure that they comply with its contract.
- 1C. Implement procedures and controls to ensure that it does not pledge and/or use its federal assets contrary to HUD's requirements. By implementing procedures and controls, the Commission should help to ensure that \$652,581 in federal assets would be appropriately used to provide decent, safe, and sanitary housing for its Public Housing households.
- 1D. Reimburse its Public Housing program \$745,436 from nonfederal funds for the improper use of funds cited in this finding.

We also recommend that the Director of HUD's Detroit Office of Public Housing

- 1E. Refer the Commission's substantial default of its contract to HUD headquarters and request that appropriate action be taken against the Commission based upon the information in this audit report.

Finding 2: The Commission Violated HUD's Section 8 Requirements Regarding the Oliver Gardens Development

The Commission violated HUD's Section 8 requirements when it performed housing quality standard unit inspections and rent reasonableness determinations for the Oliver Gardens development. This is a conflict of interest prohibited by HUD's Section 8 regulations. The improper unit inspections and rent reasonableness determinations occurred because the Commission lacked procedures and controls to ensure that its Section 8 program met HUD's requirements. As a result, the Commission improperly received Section 8 administrative fees related to the development.

The Commission Created a Conflict of Interest

In January 2006, the Michigan State Housing Development Authority approved the Commission as the management agent for the Oliver Gardens development. In addition to managing the development, the Commission inspected Oliver Garden's Section 8 housing units and performed contract rent reasonableness reviews.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.352 require a public housing agency with its own housing or substantially controlled housing to use the services of an independent party approved by HUD to perform unit inspections before assistance can be provided. HUD also requires that an independent party handle contract rent reasonableness and rent negotiations. By failing to comply with HUD's requirements regarding unit inspections and rent reasonableness the Commission not only violated HUD's requirements, but also created a conflict-of-interest relationship.

The Commission Lacks Procedures and Controls

The Commission lacked procedures and controls to ensure that federal requirements were appropriately followed. As previously mentioned, the Commission violated HUD's Section 8 requirements when it performed housing quality standards unit inspections and the rent reasonableness determinations while managing Oliver Gardens. As a result, HUD lacks assurance of the reliability of the unit inspections and that contracted rents were reasonable.

The Commission provided Section 8 assistance at Oliver Gardens without an independent third party performing the unit inspections and rent reasonableness determinations since it started on-site management in August 2007. From August 2007 to February 2008, the Commission paid more than \$35,000 in housing

assistance and received more than \$8,000 in administrative fees related to Oliver Gardens.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.152(d) states that HUD may reduce or offset any administrative fee to a public housing authority, in the amount determined by HUD, if the authority fails to perform its administrative responsibilities correctly or adequately under the Section 8 program. Given the Commission's noncompliance with HUD's requirements, it should not receive the Section 8 administrative fees. Additionally, unless the Commission improves its operations for the Section 8 program, we estimate that it could improperly receive \$14,410 (\$8,406 divided by 7 months times 12) in Section 8 administrative fees for Oliver Gardens during the next 12 months.

The executive director said that he was not aware of any conflict with HUD's Section 8 regulations by the Commission's legal counsel and plans to contract out future Section 8 housing unit inspections and rent reasonableness reviews starting in May 2008.

Recommendations

We recommend that the Director of HUD's Detroit Office of Public Housing require the Commission to

- 2A. Reimburse its Section 8 program \$8,406 from nonfederal funds for the improper administrative fees cited in this finding.
- 2B. Implement procedures and controls to ensure compliance with HUD's regulations regarding housing quality standards unit inspections and rent reasonableness determinations related to Oliver Gardens. By implementing procedures and controls, the Commission should help to ensure that \$14,410 in future Section 8 administrative fees is appropriately received.
- 2C. Discontinue performing the housing quality standards unit inspections, rent reasonableness determinations for the Oliver Gardens development, and contract with an independent third party to perform the inspections and determinations to ensure compliance with HUD's requirements.

SCOPE AND METHODOLOGY

To accomplish our objective, we reviewed

- Applicable laws; regulations; HUD's program requirements at 24 CFR [*Code of Federal Regulations*] Parts 85, 941, 970, 982, 983, and 990; Office of Management and Budget Circulars A-87 and A-133; and the Internal Revenue Service's requirements at 26 CFR [*Code of Federal Regulations*] Part 1.
- The Commission's accounting records, general ledgers, bank statements, and check vouchers and invoices for fiscal year 2007; annual audited financial statements for fiscal years 2005 through 2007; the contract with HUD; by-laws; board meeting minutes; applications for financial assistance to the State of Michigan, and consulting contracts and property appraisals.
- HUD's files for the Commission.
- The City's Ordinance 108 and applicable amendments.
- The Corporation's articles of incorporation, by-laws, board meeting minutes, accounting records, and bank statements.
- The Limited Partnership's various agreements including but not limited to the purchase, guaranty, development, operating, management, marketing, regulatory, partnership, building loan, closing escrow, mortgage loan, real estate mortgage, third-party promissory note, warranty deeds, certificate of limited partnership, and housing assistance payments contract.
- The Corporation's various agreements including but not limited to the loan, purchase, guaranty, mortgage, security, and repayable grant for the proposed development known as The Abigail; quit claim deed; the Abigail Limited Dividend Housing Association Limited Liability Company's articles of organization and operating agreement; and The Abigail Manager Incorporated's articles of incorporation and by-laws.
- The Oliver Gardens Limited Liability Company's articles of organization and operating agreement.

We also interviewed the Commission's employees and legal counsel and HUD staff.

We performed our on-site audit work between July and December 2007 at the Commission's offices located at 310 Seymour Avenue, Lansing, Michigan. The audit covered the period July 1, 2005, through June 30, 2007, and was expanded as determined necessary.

We performed our audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our objective:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weakness

Based on our review, we believe the following is a significant weakness:

- The Commission lacked procedures and controls to ensure that it complied with its contract and/or HUD's requirements regarding the pledging of the Commission's assets, use of Public Housing funds, and receipt of Section 8 administrative fees related to its affiliated entities (see findings 1 and 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		\$1,429,833
1C		652,581
1D	\$745,436	
2A	\$8,406	
2B		\$14,410
Totals	<u>\$753,842</u>	<u>\$2,096,824</u>

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations.
- 2/ Recommendations that funds to be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings, which are specifically identified. In these instances, if the Commission implements our recommendations, it will remove the pledging and/or the use of the Commission's federal assets and ensure that Section 8 administrative fees related to Oliver Gardens are earned appropriately. Once the Commission successfully improves its controls over its pledging and/or use of assets and Section 8 administrative fees, this will be a recurring benefit. Our estimates reflect only the initial year of these benefits.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



April 10, 2008

VIA FACSIMILE AND FIRST CLASS MAIL

Ms. Nikita Irons
Regional Inspector General for Audit
U S Department of Housing and Urban Development
Office of Inspector General
477 Michigan Avenue, Room 1780
Detroit MI 48226-2292

Dear Ms. Irons:

Please consider this letter as the Lansing Housing Commission's ("LHC") response to the discussion draft Audit Report of HUD's Office of Inspector General for Audit's. In preparing this response we have reviewed the March 14, 2008 Draft Audit Report, correspondence with HUD, and applicable laws and regulations.

The Audit results generally concluded with two findings:

- A. LHC defaulted on its Annual Contribution Contract by pledging, through the execution of guaranty agreements, related to LHC Non-Profit Development Corporation development of affordable housing.
- B. LHC violated HUD's Section 8 program relating to the performance of Quality Housing Standard unit inspection and rent reasonableness determinations for the Oliver Gardens development.

Each of these findings is addressed as follows:

III. Audit Results – Finding I

The specific finding is:

The Commission substantially defaulted on its contract when it executed guaranty agreements related to the Lansing Housing Commission Nonprofit Development Corporation's (Corporation) and the Oliver Gardens Limited Dividend Housing Association Limited Partnership's (Partnership) nonfederal developments. It improperly and without conditions guaranteed the obligations (\$561,933 development fees) of the Partnership's general partner, the Oliver Gardens Limited Liability Company in May 2006. Further, the Commission unconditionally and irrevocably guaranteed the full and punctual payment of loan totaling \$867,900 entered into by the Corporation in September 2006.

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The Commission also inappropriately used Public Housing funds for the nonfederal developments. The Commission inappropriately used \$745,436 (The Abigail \$499,716, Oliver Gardens \$230,760, and the Corporation \$14,960) in Public Housing funds for the nonfederal development activities as of June 30, 2007. It began inappropriately using Public Housing funds in September 2004. As a result, the Commission's Public Housing funds were not available for their intended purpose, which is to provide decent, safe and sanitary housing for low-income families, the elderly, and persons with disabilities for HUD approved housing projects.

The LHC concurs in part with Finding 1 with comment, but does not concur that the action of LHC resulted in the LHC's Public Housing funds being unavailable for their intended purposes, which it to provide decent, safe and sanitary housing for low-income families, the elderly and persons with disabilities for HUD approved housing projects.

LHC organized and incorporated the LHC Non-Profit Development Corp ("Nonprofit") for the express purpose of developing affordable housing. The Nonprofit was organized on a non-stock membership basis. LHC is the sole member, and thus controls the Nonprofit. The organization of these related entities by Public Housing Agencies is permitted by HUD. In fact, HUD published Notice: PIH-2007-15 (HA) in June 2007 to provide clarification to Public Housing Agencies for these types of related affiliates and instrumentalities. In relevant part, Notice: PIH-2007-15 (HA) provides in the purpose section:

"The U.S. Departments of Housing and Urban Development (Department) has encouraged the formation of new and innovative public and private partnerships to ensure long-term sustainability of public housing developments and the leveraging of public and private resources to transform communities. Public Housing Agencies (PHAs) continue to form and expand their relationships with private partners, including partnerships with entities related to the PHA.

The Office of Inspector General (OIG) in report No. 2004-AT-0001 has alleged violations of the Annual Contributions Contract (ACC) and regulations in agreements regarding development activities and PHA relationships with affiliated housing development entities and non-profit organizations. This notice intends to reaffirm the requirements of Public and Indian Housing Programs including the United States Housing Act of 1937 (Act), the ACC, and regulations (collectively, public housing requirements) that apply to public housing activities, including mixed-finance development activities. This notice will also assist PHAs in avoiding violations of existing requirements in development transactions with their partners. The Department intends to use this notice to focus on existing development related requirements applicable to administrative fees and development cost allocation; prohibition of conflicts of interest; the procurement of related entities; and disposition and encumbrance of public housing property. Moreover, this Notice will focus on these requirements as they pertain to Affiliates and Instrumentalities, entities through which PHAs are conducting development activities."

* * *

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The first undertaking by the Nonprofit was the development of Oliver Gardens. Oliver Gardens is a thirty (30) unit low-income senior housing development located in Lansing, Michigan. Prior to the construction of Oliver Gardens, the property was a blighted and partially abandoned trailer park. This project was financed by the Michigan State Housing Development Authority ("MSHDA"); HOME funds through the City of Lansing; and equity funds from NEF through the sale/purchase of low income housing tax credits pursuant to Section 42 of the Internal Revenue Code ("LIHTC"). The project commenced construction April 24, 2006 and was completed in August 7, 2007. LHC also received permission from HUD to administer 30 unit based section 8 vouchers for Oliver Gardens (Attachment A, letter received May 24, 2006 from HUD)

As part of the financing package, the loans from MSHDA and the City of Lansing are non-recourse. The syndication of the LIHTC with NEF required that a guaranty agreement be entered into for construction completion, LIHTC adjusters and operating deficits. Since LHC was the sponsor and the Nonprofit was a relatively new organization without financing history, it executed this guaranty agreement. We concur, that the execution of the guaranty agreement was a violation of the LHC Annual Contribution Contract with HUD. It should be noted however, that, the Guaranty Agreement had several safeguards. In particular, (1) the construction completion component was supported by the fact that the General Contractor was required to post a payment and performance bond, approved by MSHDA. These surety bonds were in place to protect the lender and the owner to ensure completion of the project should the General Contractor default in its obligations; (2) the operating deficit component was supported by the fact that an operating deficit reserve for the project was put in place in the amount of \$73,576.00. This Reserve Fund could be tapped in the event that Oliver Gardens incurred operating deficits; and (3) the guaranty of LIHTC adjusters in the event the project did not deliver the promised tax credits through eligible occupancy was supported by a market study, approved and underwritten by MSHDA. Prior to the undertaking of the project, an independent third-party market study was obtained to establish the market for this type of project.

Further, the guaranty was limited in the dollar amount of \$561,933, which was equal to the developer fee due to LHC during the course of development. Had the project incurred any of these obligations, NEF would have first setoff the amounts from developer fees payable, prior to any enforcement of the LHC guaranty.

The second portion of the funding was the guaranty executed by LHC for the development loan from Local Supportive Housing Initiatives Corp ("LISC") for the development activities of the Abigail Senior housing project. The funds from LISC were used to purchase the School for the Blind property from the State of Michigan. In fact, special legislation was passed by the State of Michigan to allow the sale of the property (see attached Attachment B). As part of the loan, LHC was requested and did execute a guaranty of this loan. This development includes the development of the Abigail Senior Housing project, an affordable senior housing development; and the relocation of the LHC administrative offices. LHC has also entered into a Buy and Sell agreement with the Lansing Housing Coalition for the purchase of one of the buildings on the site.

Thus, we concur that LHC executed the aforementioned guaranty agreements, pledging public housing funds. As you have noted, these two projects involve several components of

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MSHDA, City of Lansing and federally issued LIHTC, all for the purposes of providing affordable housing.

REMEDIES

The LHC is taking action to amend or to completely alleviate the guaranty agreements. The amended guaranty agreement or a novation will be submitted to HUD immediately upon their receipt from NEF and LISC. We expect to have this task completed within thirty (30) days.

Further, based upon the audit, LHC will implement proper controls, both administratively and through legal counsel, to ensure strict compliance of not pledging or using Public Housing funds in future affordable housing projects undertaken by the Nonprofit. Implementation is immediate.

Reimbursement of the Public Housing funds will be made over a period of time. We are requesting a ten (10) year period to repay these funds.

IV. Audit Results – Funding II

This finding was:

The Commission violated HUD's Section 8 requirements when it performed housing quality standard unit inspections and rent reasonableness determinations for the Oliver Gardens development. In January 2006, the Michigan State Housing Development Authority approved the Commission as the management agent for the Oliver Gardens development. The Commission started leasing Oliver Garden's units in August 2007. In addition to managing the development, the Commission inspected Oliver Garden's Section 8 housing units and performed contract rent reasonableness reviews. This is a conflict of interests prohibited by the Section 8 regulations.

The Commission provided Section 8 assistance at Oliver Gardens without an independent third party performing the unit inspections and rent reasonableness reviews since it started on-site management in August 2007. From August 2007 to February 2008, the Commission paid more than \$35,000 in housing assistance and received more than \$8,000 in administrative fees related to Oliver Gardens. As a result, the Commission improperly received Section 8 administrative fees related to the development.

The improper unit inspections and rent reasonableness determinations occurred because the Commission lacked procedures and controls to ensure that its Section 8 program met HUD's requirements. As a result, HUD lacks assurance of the reliability of the unit inspections and that contracted rents were reasonable.

The LHC concurs with this finding with comment.

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The basis of the finding was that Housing Quality Standard Inspections were completed by LHC staff, as opposed to independent inspectors, thus raising a conflict of interest issue. LHC provided Section 8 assistance to Oliver Gardens and performed the unit inspections and rent reasonableness reviews commencing with its on-site management in August 2007. The auditor has concluded that this was improper.

From the commencement of construction on April 24, 2006 through its completion on August 7, 2007, Oliver Gardens was highly regulated by independent third parties. Monthly inspections were conducted by MSHDA staff, the architect and the City of Lansing for plumbing, heating and electrical work. These inspections were thorough and construction continued on course. Upon completion, the City of Lansing completed a final code compliance inspection and issued certificates of occupancy. Further, MSHDA and the architect completed final inspections and authorized the occupancy of Oliver Gardens. Even though the Housing Quality Standard Inspections were conducted by experienced LHC staff persons, prior to and during the time in question, there was significant oversight by State and local authorities.

Further, rental rates must comply with HUD regulations for reasonableness, which rental rates were also subject to review by and approval of MSHDA and in accordance with Section 42 of the Internal Revenue Code due to the LIHTC's allocated to this project. Similar to the inspection process, the rents also were under the scrutiny of independent third-parties. To date no Housing Quality Standard deficiencies exist at Oliver Gardens.

REMEDIES

To avoid future conflicts of interest, or even the appearance of one, the LHC has retained the services of [REDACTED] of Housing Compliance Specialist, LLC. This independent Firm will perform all Housing Quality Standard inspections.

This procedure of independent third party inspections is documented in the policies of LHC and takes immediate effect.

V. Audit Results – Minor Deficiencies

The specific finding was:

The commission lacked a cost allocation plan to support the allocation of payroll costs among its programs and its nonprofit developments. Employees' salaries were allocated to the Commission's programs based upon unsupported estimates, in place of individual time records.

HUD's regulation at 24 CFR [Code of Federal Regulation] 85.22 requires the Commission to comply with Office of Management and Budget Circular A-87. Office of Management Budget Circular A-87, Attachment A, Section 11 (b), requires employees working on multiple activities to prepare and sign individual time records at least monthly as support for a distribution of wages that reflect a distribution of actual activity of each employee. Budget estimates do not qualify as support.

Ref to OIG Evaluation

Auditee Comments

Ms. Nikita Irons
April 10, 2008
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The LHC concurs with this finding.

REMEDIES

The LHC will begin to implement a cost allocation plan in accordance with federal regulations. These procedures and controls will maintain a cost allocation plan meeting federal requirements.

The LHC looks forward to continuing its compliance with HUD and appreciates the opportunity to respond to and implement proper procedures regarding these audit issues.

Respectfully submitted,



Chris Stuchell
Executive Director
LANSING HOUSING COMMISSION

Cc: Robert Nelson, via facsimile
Heath Wolf, via facsimile
Thomas L. Lapka, Esq., via facsimile

OIG's Evaluation of Auditee Comments

Comment 1 While the Commission disagreed with our conclusion that its Public Housing funds were unavailable for their intended purpose to provide decent, safe, and sanitary housing, it inappropriately used more than \$745,000 in Public Housing funds for nonfederal development activities. The Commission agreed to implement procedures and controls to ensure that it does not pledge and/or use its federal assets.

Appendix C

FEDERAL REQUIREMENTS

Finding 1

HUD's PIH Notice 2007-15 defines affiliates and instrumentalities and applies to public housing agency nonprofit activities pursuant to HUD regulations at 24 CFR [*Code of Federal Regulations*] Part 941. Public housing agencies may form affiliates and instrumentalities without HUD approval. Affiliates are treated like an unrelated third party. Instrumentalities are treated like the public housing agency. Public housing funds may be used to form an affiliate created to develop mixed income housing which must contain some public housing units. However, public housing funds cannot be used to form an affiliate for a housing project using only Low-Income Housing Tax Credit units or any application fees for tax credits for a development that does not contain public housing units. These costs must come from non-public housing funds.

Section 401 of the contract with HUD prohibits the Commission from using funds in its general fund for non-HUD development activities without prior HUD approval.

Section 313 of the contract with HUD states: "Unless and until all temporary notes, advance notes, permanent notes, and all other indebtedness of the local authority to the public housing authority have been fully paid (except repayment of annual contributions), and all bonds issued in connection with the project have been fully paid and retired or monies, sufficient for the payment and retirement thereof in accordance with the terms of such bonds, have been deposited in trust for such purpose with the fiscal agent, the local authority shall not transfer, convey, assign, lease, mortgage, pledge, or otherwise encumber, or permit or suffer any transfer, conveyance, assignment, leasing mortgage, pledge, or other encumbrance of such project, any appurtenances thereto, any rent, revenues, income, or receipts there from or in connection therewith, or any of the benefits or contributions granted to it by or pursuant to this contract, or any interest in any of the same."

Section 506 of the contract with HUD defines substantial default. Events of substantial default include the default of any of the provisions of section 313.

Finding 2

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.352 require a public housing agency with its own housing or substantially controlled housing to use the services of an independent third party approved by HUD to perform unit inspections before assistance can be provided. HUD also requires that the independent third party handle contract rent reasonableness and rent negotiations.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.507 state that the Commission may not approve a lease until it determines that the initial rent is reasonable. The Commission must redetermine the reasonableness of the rent before an increase in the rent if there is a 5 percent decrease in the published fair market rent in effect 60 days before the contract

anniversary or if directed by HUD. At all times during the assisted tenancy, the rent may not exceed the reasonable rent as most recently determined or redetermined by the Commission. The Commission must determine whether the rent to the owner is reasonable in comparison to rent for other unassisted units.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 983.303 states that the Commission must redetermine the reasonableness of the rent whenever there is a decrease of five percent or more in the published fair market rents in effect 60 days before the contract anniversary date; whenever the Commission approves a change in the allocation of responsibilities for utilities between the owner and the tenant; whenever the housing assistance payments contract is amended to substitute a different unit in the same building; and whenever there is a change that may substantially affect the reasonable rent.